

Merits and Demerits of Direct Taxes

(A) Merits:

1. Equity:

A direct tax is an equitable tax. Through it the rich can be made to pay more than the poor. In case of necessity, the poor people can be granted exemption from payment of such taxes.

A direct tax is equitable in the sense that it is levied according to the taxable capacity of the people. The rates of direct taxes, like the income tax, can be fixed in such a way that the higher the income of a man, the greater is the rate at which he has to pay the tax. Such a system is known as progressive taxation.

2. Certainty: A direct tax satisfies the canon of certainty. For instance, a person liable to pay income tax knows how much he will be required to pay; for that purpose he can appropriate steps beforehand.

3. Elasticity:

A direct tax has elasticity. It can be varied according to the needs of the government and changes in the income of the people. When the income of the people goes up, the rate of income tax can also be increased. If the income of the people falls, the rate of income tax can also be lowered.

4. Productivity:

Direct taxes constitute an important source of government revenue. Their collection charges are also low. Therefore, direct taxes are productive.

5. People's Consciousness:

A direct tax increases the civic sense of the people. When the people are fully aware of the payment of taxes, they are also conscious of the way the government spends the money. They resent unproductive or wasteful expenditure. As a result, the government becomes careful in its expenditure.

(B) Demerits:

But direct taxes have certain demerits or defects, too.

These are:

1. Lack of Popularity:

First, such taxes are not very popular, because the people have to bear the burden of such taxes directly. That is why, when the rate of a direct tax is raised, most people express their resentment against the government. For instance, when the rate of personal income tax or corporate profit tax is raised, criticism from those affected becomes very strong.

2. Evasion:

The second disadvantage of a direct tax is that it is liable to be evaded. By submitting false returns, many people try to evade income tax. Unless the civic sense of the people is well — developed and there is spread of education among them, the administration of direct taxes is very difficult.

3. People's Indifference:

The third disadvantage of a direct tax is that it does not develop the civic sense of those who do not pay such taxes. In the case of income tax, people with incomes below a certain level are not liable to pay tax. In a low-income country like India, the majority of the people are not required to pay income tax. When a man directly bears the burden of a tax, he tries to know how the government spends that

money. Those who are not directly affected by the burden of taxation remain indifferent as to the way the public expenditure is incurred.

4. Disincentive to Work and Save:

Another disadvantage of direct taxes is that they reduce the desire to work and save. The rate of direct taxes are usually high. Many business ventures are not undertaken on the ground that a large part of the income earned will have to be given to the government in the form of taxes. Thus, direct taxes reduce incentives to work hard and save.

As the direct taxes have these defects, in a good tax system there should be indirect taxes, too.

Indirect Tax: Merits and Demerits| Tax System

Merits of Indirect Tax:

Indirect taxes have the following advantages:

(a) Convenience:

Indirect taxes are less inconvenient and burdensome to the taxpayer than the direct taxes. Since taxes are included in the price of the taxed commodity the taxpayer does not feel the burden of the taxes. It is convenient also because these taxes are not paid in lump-sum amount unlike direct taxes.

Sometimes, the consumer may not be aware of the fact that he pays tax. Above all, an indirect tax can be avoided by not buying taxed commodities. But, once a taxpayer crosses the threshold limit, he or she will have to pay direct taxes. For all these reasons, indirect taxes are both convenient and burden-free.

(b) Broad-Based:

Indirect taxes are broad-based since the effects are felt by more or less all the people in the community. Direct tax, on the other hand, has a narrow base. The lower income group is not required to pay income tax but he cannot escape the indirect tax net once he purchases a tax-imposed commodity.

(c) Elastic and Productive:

Elasticity and productivity are the other merits of indirect tax. It is flexible or elastic in the sense that it can be revised in accordance with the requirements of the government. It is also revenue-yielding since its bases are wide.

(d) Difficulty in Evading Taxes:

It is difficult to evade indirect tax since such tax is included in the price of the commodity even if the rate of tax is high.

(e) Social Objective:

Indirect taxes are often levied on harmful and luxury goods whose consumption has to be curtailed so as to promote social welfare. Thus, an indirect tax has a social purpose.

(f) Important Anti-Inflationary Measure too:

It is said that indirect taxes, as contrasted to direct taxes, are more effective in controlling inflation. Truly speaking, indirect taxes may fuel inflationary pressure in the economy.

Demerits of Indirect Tax:

Its disadvantages are equally significant:

(a) Regressive in Character:

As these taxes fail to satisfy the principle of distributive justice, it is considered to be a regressive tax.

Principle of progressiveness is violated since the burden of an indirect tax falls upon all persons indiscriminately, irrespective of their ability to pay. As these taxes are not levied in accordance with the principle of ability to pay, burden of taxes mostly falls upon the poorer persons. Thus, these taxes are unjust and inequitable.

(b) Uncertain Revenue Earning:

It fails to satisfy the Smithian canon of certainty because the revenue accruing from indirect taxes cannot be estimated properly. As soon as a tax on a commodity is imposed its price rises. The law of demand states that there will be a fall in quantity demanded following this price rise.

How much the demand will fall consequent upon the imposition of taxes cannot be estimated accurately. So is the revenue-yielding capacity of taxes. Thus, an element of uncertainty is involved in indirect taxes.

(c) Unproductive:

It is uneconomical since the cost of collecting indirect taxes is rather high. In this sense, some of the indirect taxes are unproductive.

(d) Civic Consciousness not Created:

These taxes do not create civic consciousness as its burden is not clearly felt by the taxpayers. They lack interest in making a vigil on government expenditure. However, this is not true, particularly when the rate of indirect taxes becomes high. Excessive dose of taxation often leads to public protest against the government's taxation policies.

(e) Possibility of Evasion:

Indirect taxes are also evaded by taxpayers. Development of an unholy alliance between buyers and sellers may result in tax evasion. Usually, buyers evade taxes by not accepting 'receipts of sale' from the sellers. Sellers also evade these taxes by not maintaining legal accounts book.

(f) Wage-Price Push:

Finally, instead of being an anti-inflationary device, increased rates of indirect taxes have the potentiality of fuelling cost-push inflationary pressures in the economy. Higher prices consequent upon high rate of tax result in higher costs, higher wages, and again higher prices. A wage-price spiral is thus initiated.

(g) Of the two, which one is preferred?

Most of the demerits of these two types of taxes are administrative. By plugging the administrative loopholes, a government can remove some defects of the tax system (e.g., evasion of taxes). However, from the standpoint of equity and distributive justice, a direct tax is more preferable to an indirect one.

Direct taxes can establish economic equality as they are levied on richer sections of the community while indirect taxes affect adversely the poorer people. But this does not mean that indirect taxes are incapable of reducing disparities in income and wealth.

By imposing taxes on luxuries, the government can bring the richer people within the tax net. So, we can say that in a good taxation system, there must be a proper balance between direct and indirect taxes. Besides this, in recent times, government activities have increased phenomenally.

So reliance on direct tax is not enough. Indirect taxes are imposed to collect more revenues.

Further, in a developing economy, indirect taxes can be geared to mobilize resources for development purposes:

To promote savings and desired investment, to make proper resource allocation, to control inflation, etc.

To fulfil revenue and non-revenue objectives of taxes, both taxes are necessary. These two types of taxes must not be viewed as competitors; they are, in fact, complementary. For these reasons, in every country there is the combination of both direct and indirect taxes.